

**COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY**

BLACKSTONE GAS COMPANY

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D.T.E. 01-50

**INITIAL BRIEF OF
THE ATTORNEY GENERAL**

Respectfully submitted,

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I. INTRODUCTION

Pursuant to the briefing schedule established by the Department of Telecommunications and Energy (“Department”) in this proceeding, the Attorney General submits this Initial Brief which addresses the Petition of Blackstone Gas Company for a General Increase in Gas Rates (the “Petition” or “Filing”). The Attorney General has reviewed the Petition and the related supporting evidence together with various discovery documents and materials and has determined that the amount of the requested increase is excessive, unwarranted and/or otherwise not supported by the evidentiary record before the Department.

As is customary in this type of proceeding, the final recommendations of the Attorney General concerning the Company's revenue requirements will be provided in schedules attached to the Reply Brief.

A. STATEMENT OF THE CASE

On May 15, 2001, Blackstone Gas Company (“Blackstone” or the “Company”) filed tariffs with the Department seeking to increase its base rates by \$220,067, an increase of 36% over

Blackstone's existing base rates.¹ On June 1, 2001, the Department suspended the effective date of the rate increase until December 1, 2001, and opened an investigation into Blackstone's requested increase.² On June 27, 2001, the Department conducted a public hearing ("Public Hearing") at the Blackstone Municipal Center.³ On July 9, 2001, the Department conducted a procedural conference. Evidentiary Hearings were held on August 22 and 24 of 2001.⁴ During the Evidentiary Hearings, Blackstone presented the testimony of Lee Smith on issues of revenue requirement, rate design, and cost allocation.⁵ Blackstone also presented the testimony of its President, Mr. James Wojcik.

B. DESCRIPTION OF THE COMPANY

Blackstone is a small investor-owned utility with approximately five (5) employees and total annual revenues of approximately \$1.1 million. Blackstone distributes and sells gas at the retail level serving approximately one thousand (1,000) customers, both residential and commercial, in the towns of Blackstone and Bellingham in Massachusetts. Blackstone presently purchases all of its gas

¹ Exh. B-1, exhibit 2, schedule 1. During the first day of the Evidentiary Hearings, the Company revised the proposed increase downwards to \$209,995. Exh. B-2. Thereafter, on the second day of Evidentiary Hearings, the Company again revised the proposed increase this time claiming the correct figure was \$211,380. Exh. B-3. Finally, on September 4, 2001, Blackstone again revised its revenue requirement or revenue deficiency figures and now claims that it is entitled to an increase in the amount of \$162,702—a figure which is \$57,365 or 26% less than the amount originally requested in its Petition. Exh. B-4. The most recent revised proposed increase constitutes 27% of Blackstone's annual base revenues.

² The test year is the twelve month period from January 1, 2000 to December 31, 2000.

³ The Attorney General delivered a Public Statement at the Public Hearing. Mr. James Wojcik, President of Blackstone, who was present together with the legal counsel for the Company, submitted a written statement.

⁴ On July 30, 2001, prior to the commencement of the Evidentiary Hearings, Blackstone filed a request for a waiver ("Waiver Request") from the Service Quality Standards mandated by the Department in its Order and Guidelines issued on June 29, 2001, in docket D.T.E. 99-84. The Department docketed the Waiver Request in this docket, D.T.E. 01-50, and requested comments. During the Evidentiary Hearings, the Hearing Officer ruled that evidence and argument regarding the Waiver Request would be postponed until a later date.

⁵ Lee Smith is a Senior Economist at La Capra Associates.

energy requirements from Duke Energy (“Duke”). Tr. 2, p.183. Blackstone’s agreement with Duke provides for two types of gas service----base supply and supplemental supply. Exh. B-1, p.12-13. Blackstone owns rights to transport 518 MMBtu per day over the Tennessee Gas Pipeline and currently exercises those rights to deliver its base supply. *Id.*

Blackstone has a non-regulated affiliate, Blackstone Sales and Service, a “propane” company with approximately two employees and total revenues of approximately \$575,000. Exh. AG-1-14, AG-3-4, AG-3-5 and Tr. 1, p.68-72. Blackstone Sales and Service primarily sells propane and installs propane tanks, but is also engaged in the business of appliance repair. Tr. 1, p.69. Blackstone Sales and Service likewise serves the towns of Blackstone and Bellingham. Blackstone Sales and Service also shares both space and expenses with Blackstone. Tr. 1, p. 69 and Exh. AG-1-15.

II. REVENUE REQUIREMENT

A. OVERVIEW

Blackstone’s original Petition sought a base rate increase in the amount of \$220,067. Exh. B-1, exhibit 2, schedule 1. After a number of revisions, Blackstone concluded that it had overstated or otherwise improperly inflated its revenue requirement calculations by approximately 26%, or \$57,365. Accordingly, on September 4, 2001, Blackstone revised its revenue requirement figures to reflect Blackstone’s new and reduced proposed base rate increase of \$162,702. Exh. B-4, schedule 1. Blackstone’s revised requested increase constitutes a 27% increase in the Company’s annual base revenues.

The Attorney General submits that, despite the Company’s revisions, Blackstone’s request is still excessive and unwarranted. An analysis of Blackstone’s proposed revenue requirement

demonstrates that the Company: (1) appears to be over-billing its customers, as is indicated by its persistent balances of “negative”, unaccounted for, gas; (2) failed to follow Department precedent in arriving at the Company’s revenue requirement; (3) miscalculated various aspects of its pro forma income tax; (4) failed to allocate common costs to an affiliate company; and (5) improperly added routine incremental post-test year plant additions to the rate base. Accordingly, the Attorney General urges the Department to adopt the recommendations set forth below and dismiss the Company’s requested distribution rate increase.

B. THE COMPANY’S BOOKS AND RECORDS INDICATE THAT THE COMPANY’S PAST YEAR’S BILLINGS ARE INACCURATE

Blackstone’s Annual Returns to the Department indicate that during the past 4 years, the Company has routinely billed its customers for more gas than it has received from its suppliers at the city gate. The annual volumes the Company received from suppliers and the amounts it billed to customers are as follows:

TABLE 1:
**UNACCOUNTED FOR MCF GAS VOLUMES AND
PERCENTAGES FOR THE PERIOD 1997 THROUGH 2000**

Year	Citygate Sendout	Billed To Customer	Company Use	Total Accounted	Unaccounted (Overcounted)	Percent
1997	104,541	109,063	389	109,452	(4,911)	(4.49%)
1998	100,213	97,478	389	97,867	2,346	2.34%
1999	100,102	103,706	470	104,176	(4,074)	(4.07%)
2000	<u>98,205</u>	<u>112,751</u>	<u>616</u>	<u>113,367</u>	<u>(15,162)</u>	<u>(15.44%)</u>
TOTAL	<u><u>403,061</u></u>	<u><u>422,998</u></u>	<u><u>1,864</u></u>	<u><u>424,862</u></u>	<u><u>(21,801)</u></u>	<u><u>(5.41%)</u></u>

See Annual Returns to the Department for the years 1997, 1998, 1999 and 2000, Exh. AG-1-2.

Blackstone's Annual Reports for three of the last four years clearly indicate that the Company has sold more gas to its customer than it has received--on average 5.41 percent more. The results of the past year are the most disturbing: in the year 2000, the Company billed 15.44 percent more in volumes than it has received.

During the hearing, the Company's witness, Ms. Smith, attempted to explain these overbillings by suggesting that the pipeline's meter at the city gate was not functioning correctly. Tr. 1, pp. 64-66. However, because she was unable to support those statements with any evidence, Ms. Smith instead relied upon her judgement that the bills *seemed* correct. *Id.* Ms. Smith's bald assertion regarding customer usage, that "[t]hese numbers are very similar to what you see in other companies" is without any factual support. *Id.* The company does not maintain any records of the historical billing determinants needed to perform a bill frequency analysis, much less a typical bill

analysis. Tr. 1, p. 66 and pp. 102-103. The only substantiated evidence in the record are the invoices received from the Company's pipeline supplier and the amounts billed by the Company to its customers, each of which show these unusual discrepancies.

Until these discrepancies are reconciled and the Department obtains clear evidence that the Company is not over-billing its customers, the Department should bar the Company from increasing its base rates. The books and records of the Company are inconsistent with and contradict its rate filing. Department precedent requires dismissal of the rate case. *See Fryer v. Department of Public Utilities*, 374 Mass. 685, 691 (1978) (unreliability of utility records supports ruling that company books and records did not permit the establishment of new rates). The Attorney General requests that the Department reject the proposed rate increase until the Company explains all discrepancies.⁶

⁶ The Company could install its own meter on its side of the city gate in order to verify Ms. Smith's allegations.

C. COST OF CAPITAL

1. THE COST OF CAPITAL SHOULD INCLUDE ALL OF THE COMPANY'S DEBT

The cost of service includes a return on rate base which provides Blackstone's investors a return on the net investment that they have made in its utility business. Exh B-1, exhibit 2, schedule 4. The return compensates the debt holders and the common stockholders for their investments in the Company's gas distribution business. Exh. B-1, exhibit 4. The dollar amount of the return is determined by multiplying the dollar amount of the rate base by the overall cost rate of these different costs of capital weighted by the amount outstanding of each. *Id.* As will be discussed below, the flaws with Ms. Smith's analysis cause her results to greatly overstate the Company's cost of capital.

The Company's original proposal for its capital structure included only a portion of the debt that it uses to finance its construction and operations, and failed to include all of its long-term debt and short-term debt. This methodology overstates the overall weighted cost of capital and the associated income taxes.¹ Exh. B-1, exhibit 4. The Company proposed to include only \$290,821 of its notes payable as debt in its capital structure. *Id.* However, this balance fails to account for the other debt on the Company's books that it admittedly used to finance its plant. Ms. Smith testified at great length that the Company builds its system on short-term debt and other borrowings, including deferral of payments on accounts payable in order to minimize the need for further common shareholder investment. *See* Exh. AG-2-1, AG-2-19, and Tr. 1, p. 21. However, when she first determined the sources of the Company's financing to calculate the overall cost of capital, she ignored these other forms of debt. Exh. B-1, exhibit 4. It was not until September 4, 2001, after the

close of hearings, that the Company filed what appears to be their last, in the line of many, proposed revenue requirement calculations in which it finally included in the capital structure (what appears to be) all of its debt. *See* Exh. B-4, exhibit 4. To determine the overall weighted cost of capital, the Department should consider all of these financial resources including all debt on the Company's books.

D. RATE BASE

1. THE COMPANY'S POST-TEST YEAR PLANT ADDITIONS SHOULD BE REJECTED

The Company proposes to make four separate adjustments to its rate base for post-test year plant additions.⁷ The plant additions are: (1) a International dump truck; (2) a Chevrolet Express truck; (3) computer software; and (3) tools and other shop equipment. Exh. B-1, exhibit 2, schedule 4. The Department should reject these plant additions since none of them is extraordinary in amount.

The Department's precedent regarding a company's post-test year additions to rate base is well-settled. *Nantucket Electric Company*, D.P.U. 91-106/138, pp. 90-91 (1991); *Western Massachusetts Electric Company*, D.P.U. 1300, pp. 14 -18 (1983); *King's Grant Water Company*, D.P.U. 87-228, pp. (1988); *Fitchburg Gas & Electric Light Company*, D.P.U. 1214, pp. 4-5 (1983). Generally, the Department uses test-year end rate base, excluding ordinary plant additions occurring after the close of the test-year, to determine the net investment in utility services for which the utility can recover costs, including a return. *Western Massachusetts Electric Company*, D.P.U. 1300, pp. 17-18 (1983). *Edgartown Water Company*, D.P.U. 62, p. 3 (1980); *Western Massachusetts Electric Company*, D.P.U. 558, p. 8 (1981). However, the Department does allow certain extraordinary post-test year additions to the rate base. In *Nantucket Electric Company*, D.P.U. 91-106/138 (1991), the Department stated that it "consider[s] both the size of the capital investment and the significance of the increase on a company's rate base" In *Western Massachusetts Electric Company*, D.P.U.

⁷ The Company, without comment or explanation, appears to have corrected a calculational error in its determination of its rate base. Specifically, in its original and first supplemental cost of service schedules, the Company added the balance of deferred income taxes to rate base rather than subtracting that amount. This error had the effect of overstating rate base by \$ 165,884 [\$82,942 x 2]. Compare Exh. B-1, exhibit 2, schedule 4, and Exh. B-2, exhibit 2, schedule 4 with Exh. B-4, exhibit 2, schedule 4.

1300, the Department reasoned:

Ordinary plant additions occurring after the close of the test year are excluded from rate base, in part because, while normal additions may be easily identified, offsetting periodic retirements from plant in use are not. Therefore, the Department viewing these changes as balancing one another, has tended to adhere to the rate base structure as it occurred during the test year.

[Cites omitted.]

The Attorney General submits that none of the Company's proposed post-test year additions to rate base meet the Department's requirements to be included in the rate base.

First, each of the proposed adjustments to rate base is too small. The International truck of \$61,469 is only 4.27 percent of the test-year end rate base. Tr. 1, p. 33. The Chevrolet Express truck represents only 2.03 percent of rate base. Tr. 1, pp. 32-33. Equally, the computer software additions represents only 0.59 percent of rate base. Tr. 1, pp. 33-34. Finally, the tools and other shop equipment only represent 0.78 percent of rate base. Tr. 1, p. 34.

Clearly, each of the post test-year plant additions is simply a routine incremental addition to plant in service. Since none of these plant additions are significant in relation to the Company's rate base, the Department should reject these additions and reduce the Company's proposed cost of service accordingly.⁸ *Nantucket Electric Company*, D.P.U. 91-106/138, pp. 90-91 (1991); *Western Massachusetts Electric Company*, D.P.U. 1300, pp. 14 -18 (1983).

2. CASH WORKING CAPITAL FOR GAS COSTS SHOULD BE UNBUNDLED

The Company has filed a proposed CGA tariff that includes a gas working capital allowance.

⁸The Department should also recognize that the Company failed to find any post test-year increases in revenues. The Department should reject any attempt to increase its test year end rate base without evidence that the Company conducted a post-test year revenue analysis. Both additions and revenues must be looked at.

Exh. B-1, exhibit 10, M.D.T.E. NO.72. For the most part, this tariff provision is consistent with Department precedent regarding the recovery of gas working capital costs through the CGA. *See Boston Gas Company*, D.P.U. 88-67 (Phase I), pp. 40-43 (1988). The Company's witness explained that this was not really what the Company was proposing—the Company would prefer to include gas cost related working capital in its base rates. Tr. 1, pp. 98-100. The Company fails to provide any testimony or evidence supporting this proposal that is contrary to the unbundling of gas rates approved by the Department in the various unbundling dockets. *See Commonwealth Gas Company*, D.T.E. 98-63 (1998); *Colonial Gas Company*, D.T.E. 98-64 (1998); *Berkshire Gas Company*, D.T.E. 98-65 (1998); *North Attleboro Gas Company*, D.T.E. 98-66 (1998). The Department should reject the Company's proposed deviation from the unbundling precedent. The Department should order the Company to remove all gas costs and all other costs the Company will recover through its adjustment clause provisions from both the base rate working capital allowance and from the computation of its inflation allowance. In addition, the Company's CGA tariff incorporates a cost of capital rate that reflects only the Company's cost of equity capital. Exh. B-1, exhibit 10, M.D.T.E. NO.72, Sheet No. 2 of 3. This too must be modified. Blackstone's CGA must be modified to comport with all other LDC CGA carrying cost rate calculations.

E. EXPENSES

1. THE COMPANY'S PROPOSED UNCOLLECTIBLE DEBT EXPENSE ADJUSTMENT DOES NOT COMPLY WITH DEPARTMENT PRECEDENT

The Department allows utilities to include in the cost of service used to determine rates an expense amount – bad debt or uncollectible expense -- associated with those revenues which the utility bills for, but never collects from the customer. As the record shows in this case the expense amount of uncollectible debt varies tremendously from year-to-year:

<u>Year</u>	<u>Booked Uncollectible Expense</u>
2000	\$15,311
1999	5,066
1998	5,841
1997	12,116
1996	7,699
1995	12,156

Exh. AG-1-2, Annual Returns to the Department, p. 47, line 6.

The Department has determined that the amount of uncollectible expense allowed in the cost of service should be representative of the level that the utility is likely to expense in the future. *Western Massachusetts Electric Company*, D.P.U. 85-270, p. 180 (1986).

The Company, in this case, proposes to determine its pro forma bad debt expense amount

based on the percent of write-offs to revenues for the short period of 13 months, including the test year. Tr. 1, p. 44. The Company's witness provided no argument for this methodology, or why it would be appropriate as the basis for a pro forma adjustment. She made no showing that this methodology results in a pro forma expense amount that is representative of the level that the utility is likely to expense in the future. Moreover, she did not provide any evidence to contravene the Department's current precedent and why she believes that it is inappropriate.

The Department precedent on the calculation of bad debt or uncollectibles expense is well established. *Fitchburg Gas & Electric Light Company*, D.T.E. 98-51, pp.49-51 (1998); *Boston Gas Company 96-50 (Phase I)*, pp. 70-71 (1996); *Commonwealth Electric Company*, D.P.U. 89-114/90-331/91-80, pp. 137-140 (1991). The Department has found that:

To determine the amount of uncollectibles, a company performs a calculation that includes averaging the most recent three years' net writeoffs and applying the average to determine the percentage of [weather] adjusted test-year revenues it represents, i.e. the uncollectible ratio. D.P.U. 96-50 (Phase I) at 70-71; D.P.U. 90-121, at 96-97; *Western Massachusetts Electric Company*, D.P.U. 84-25, at 113-114 (1984).

A three-year weighted average of net write-offs to total revenues is used to derive the uncollectible expense because it provides a more accurate representation of the level of uncollectible expense which the Company is likely to experience in the future. *Western Massachusetts Electric Company*, D.P.U. 85-270, p. 180 (1986). Citing *Boston Edison Company*, D.P.U. 1720, (1985).

The Company provided no argument or evidence in this case that should cause the Department to deviate from this precedent.

The Company's three-year average percentage of net write-offs to revenues can be calculated from the information in the record. *See* Exh. AG-1-53. The data included is the following:

<u>Year</u>	<u>Gross Write-Off</u>	<u>Recoveries</u>	<u>Net Write-Offs</u>	<u>Revenues</u>	<u>Percent</u>
2000	\$15,648	\$337	\$15,311	\$1,128,794	1.356%
1999	5,066	2,012	3,054	915,290	0.334
1998	5,841	1,177	<u>4,664</u>	<u>897,067</u>	0.513
			<u>\$23,029</u>	<u>\$2,491,151</u>	<u>0.783%</u>

Exh. AG-1-53.

Thus, the Department, consistent with its precedent, should allow the Company to include pro forma bad debt expense based on 0.783 percent of the Company's normalized revenue. *Id.*

2. THE COMPANY'S PROPOSED WAGE INCREASES ARE GROSSLY EXCESSIVE AND SHOULD BE LIMITED TO THE RATE OF INFLATION

The Company proposes to make a pro forma increase for the wages paid to its employees. Exh. B-2, schedule 3. The increase includes an annualization of the year 2000 wage increases as well as an inflation of wages from the midpoint of the test year to the midpoint of the rate year. *Id.* The annualization of wages provided a range of increases from 5.88 percent to 36 percent for certain employees with the average of 17.82 percent. Tr. 1, pp. 53-54. On top of this increase, the Company proposes another increase to inflate test year wages by another 2.98 percent through the inflation adjustment. Exh. B-1, pp. 9-10. As will be discussed below, the wage increases given during the test year were unreasonably high and should be rejected by the Department. Furthermore, these wage expenses should be removed from the inflation adjustment.

The Department's precedent requires that wage increases for non-union employees be reasonable and in line with similar utility employees of other companies. In deciding the propriety

of prospective non-union wage adjustments, the Department applies a three part standard. *See Boston Gas Company*, D.P.U. 96-50 (Phase I), p. 42 (1996) citing *Fitchburg Gas & Electric Light Company*, D.P.U. 1270/1414, p. 14 (1983). To meet this standard, a company has the burden of demonstrating (1) an express commitment by management to grant the increase, (2) an historical correlation between union and nonunion raises, and (3) an amount of increase that is reasonable. *Id.*

Here, the Company fails to meet the third part – the reasonableness of the increases granted to employees.⁹ The Company did not provide any general surveys of wages and salary increases to show the reasonableness of its proposed increases.¹⁰ Furthermore, as the Company's witness recognized, inflation has been less than 3 percent during the last year or so, clearly indicating that increases of the proposed magnitude of 17.82 percent are unreasonable. Tr. 1, p. 54. Therefore, the Department should deny the Company's proposed increase in wages, and limit any increase to the rate of 3 percent so that base rates are conservatively based on wage increases that are no greater than the inflation to which its witness testified.

Finally, as will be discussed *infra*, the Department has found that pro forma adjustments should be removed from the test year cost amount of operation and maintenance expenses being inflated in the inflation adjustment. *Boston Gas Company*, D.P.U. 93-60, pp. 192-193 (1993); and *Boston Gas Company*, D.P.U. 88-67, Phase I, p. 140 (1988). Since the Company has already adjusted its test year cost of service for wage increases for its employees, all of those costs should be removed from the inflation adjustment. Exh. B-1, pp. 9-10. In this case, those test year wages

⁹ The Company has met the first part of the test and the second part is not applicable (given that there are no unions).

¹⁰ The Company did provide the salaries of the managers of two larger utilities for comparison to the president of Blackstone. Exh. DTE-1-15. However, these comparisons are inappropriate for three reasons. First, they are not surveys, but rather two individual data points with no proof that they are representative. Second, the Company makes an apples and oranges comparison since these other positions are with larger corporations that are combined utilities and managers who do not have an equity interest in the corporation. Third, the increases only represent those for one position within the Company, not the general survey that is required.

included in the cost of service are \$193,991 and this is the amount that should be removed from the test year operations and maintenance expense balance being inflated. Exh. AG-2-7.

**3. THE COMPANY'S PRO FORMA LIABILITY INSURANCE
EXPENSE INCREASE SHOULD BE ALLOCATED TO THE
COMPANY'S AFFILIATE**

The Company proposes to increase its test year cost of service by \$5,886, from \$20,544 to \$26,430, for increases in its general liability insurance costs. Exh. B-2, Schedule 3 and Exh. AG-3-12. The new pro forma expense amount is based on the latest bills that the Company has received for the period April 5, 2001 to April 5, 2002. *Id.* However, the Company has failed to assign or allocate any part of this cost to its affiliate, Blackstone Sales and Service. Tr. 1, p. 75.

The Department requires that reasonable allocations be made to utility affiliates that share assets and costs with the utility. *See e.g., Berkshire Gas Company*, D.P.U. 92-210, p. 5 (1993). Here, since the Company has not allocated any of the pro forma liability insurance expense to the Company's affiliate, the Department should impute a value. Specifically, the Department should reduce the pro forma liability insurance expense included in the cost of service by 32.9% or \$8,804 (\$26,430) based on the general allocator used by the Company to allocate common costs. Exh. RR-AG-9.

**4. THE COMPANY FAILED TO ALLOCATE ANY OF THE
OFFICERS' SALARIES AND BENEFITS TO THE COMPANY'S
AFFILIATE**

The Company proposes to recover all of the costs of the corporate officers through its gas service base rates. That is, none of the salaries or benefits of the officers have been allocated to the Company's affiliate -- Blackstone Sales and Service-- even though that business is half as large as the gas distribution business. Exh. AG-3-6.

The Department requires that reasonable allocations be made to utility affiliates that share assets and costs with the utility. *See e.g., Berkshire Gas Company*, D.P.U. 92-210, p. 5 (1993). Since the Company has not allocated any of the corporate officers salaries or benefits to the Sales and Service affiliate, the Department should impute a value. The total wages paid to the Company's officers were \$101,128 [\$76, 113 + \$25,015 from Exh. AG-1-24] and the benefits for the Company officers were \$6,926 for health benefits [\$3,463 x 2 from Exh. AG-1-35] and \$3,333 for IRA benefits [\$1,667 x 2 from Exh. AG-3-11] summing to a total compensation of \$111,387. Since the allocator to the affiliate that the Company uses was 32.9 percent, the total amount that should be allocated to the Sales and Service affiliate is \$36,646. Exh. RR-AG-9. Thus, the Department should order the Company to reduce its pro forma cost of service by \$36,646 to remove that portion of officers compensation appropriately allocatable to its affiliate.

5. THE COMPANY'S PROPOSED INFLATION ADJUSTMENT FAILS TO FOLLOW DEPARTMENT PRECEDENT

The Company includes in its pro forma cost of service an inflation adjustment to reflect the general effects of inflation on the Company's costs. Exh. B-2, Schedule 3. In this case, the Company has determined its inflation adjustment by simply deducting one item--gas costs-- from the Company's operations and maintenance expenses and multiplying the difference by an inflation factor.¹¹ *See* Exh. AG-2-9, and AG-2-10. As will be discussed below, the Company's inflation calculation is inconsistent with the Department's precedent, which requires the removal from the inflation adjustment of all expenses that are either (1) adjusted for elsewhere in the proposed rates, or (2) are fixed in nature.

¹¹ The inflation factor proposed by the Company reflects the change in the price index between the midpoint of the test year in this case and December 31, 2001.

The Department's long-standing precedent regarding the inflation adjustment is well-settled. The inflation allowance is applied only to those operations and maintenance expense items which have not been separately adjusted in the cost of service. *Boston Gas Company*, D.P.U. 93-60, pp. 192-193 (1993); and *Boston Gas Company*, D.P.U. 88-67, Phase I, p. 140 (1988) (where the Department noted that [t]he purpose of an inflation allowance is to compensate a utility for the effect of inflation on those O&M expense which are not otherwise accorded separate treatment in the utility's cost of service."). Here, the Company has failed to remove the test year amounts of the expense for which it proposes pro forma adjustment in this case. Tr. 1, pp. 46- 51 and Exh. RR-AG-7. The test year amounts for which pro forma adjustments have been provided include: (1) wage and salaries expense of \$193,991 (as discussed *supra*); (2) bad debt expense of \$15,311; (3) unbundling expense of \$25,246; and (4) liability insurance expense of \$23,133. See Exhibits AG-2-7; RR-AG-6; B-1, exhibit 2, schedule 3; and Tr. 1, p. 87, respectively. The Department should reduce the balance of operation and maintenance expense to which the inflation factor is applied by the unadjusted test year amounts of each of these expenses.

The Company, again in contravention of Department precedent, also failed to remove from the inflation adjustment those costs that are fixed in nature, and are thus unaffected by inflation. These costs include the test year rent and lease expense in the amount of \$14,438. Exh. RR-AG-8.

Finally, to the extent that the Department orders other adjustments to the Company's operation and maintenance expenses in this case, those expenses should also be removed from the inflation adjustment calculation.

6. THE INTEREST DEDUCTION THAT THE COMPANY USES IN ITS INCOME TAX CALCULATION DOES NOT CONFORM TO DEPARTMENT PRECEDENT

The Company proposes to use actual test year interest expense associated with certain debt issues to determine the taxable income in its income tax calculation. As will be discussed below, the Company's proposal is incorrect since (1) it does not conform to Department precedent regarding the interest expense deduction and (2) it does not include all debt available to the Company.

The Department's precedent regarding the pro forma income tax expense is well-established. *Boston Edison Company*, D.P.U. 906, pp. 62-65 (1982); *Fitchburg Gas & Electric Light Company*, D.P.U. 1270 / 1414, p. 46 (1983). The Department uses a return on rate base methodology to determine income taxes, rather than attempting to determine the actual taxes being paid each year. This income tax methodology determines a utility's gross income as the return on rate base – the test year end rate base times the overall weighted cost of capital. From this gross income amount, interest expense is deducted to determine the after tax income. The interest expense deduction is also based on the return on rate base methodology – the test year end rate base times the debt component of the overall weighted cost of capital. *Id.* This methodology synchronizes the taxes with the year end rate base and the capital structure.

The Company's proposed income tax calculation does not conform to Department precedent. Rather than using the return on rate base methodology, the Company simply uses its actual test year Account 431 – Other Interest Expense amount. *Compare* Exh. B-4, exhibit 5 with the Company's Year 2000 Annual Return to the Department, p. 10, line 37. This methodology understates the interest expense and causes a proportional increase in the pro forma income taxes. The Company's actual test year interest expense was \$39,090. The amount using the Department's return on rate

base methodology and the Company's proposed rate base and capital structure would calculate an interest expense deduction of \$69,209 [rate base x debt component of overall cost of capital = \$1,361,658 x 5.08%].¹² Exh. B-4, exhibits 4 and 5.

The Company provided no evidence and no new argument in this case that should cause the Department to change is longstanding precedent regarding the return on rate base methodology for determining pro forma income taxes. Therefore, the Department should reject the Company's use of actual test year interest expense as the interest deduction used to determine income taxes and should instead use the amount determine as the debt component times the test year end rate base.

F. RATE DESIGN

1. THE COMPANY'S DISCOUNTED SCHOOL RATE MUST BE ALIGNED WITH COSTS

During the test year, the Company provided service under a special contract to a school in the town of Blackstone. Originally, the school converted from oil and was supplied with natural gas through a special arrangement with Distrigas. The base rate pricing terms of the contract were lower than the Company's commercial tariff rate. After the special arrangement with Distrigas, ended the Company and the school signed a new contract that included a CGA component and an increase in the base rate component, nevertheless, the base rate was still below the "full cost of service"(i.e., discounted). Tr. 1, p. 94 and Exh. B-1, p. 5. Although the contract has expired and has not been renegotiated, the Company continues to serve the school under rates specified in the contract. *Id.*

In this case, the Company has proposed a school tariff that would apply to this customer only.

¹² The debt component of the overall weighted cost of capital is calculated as the overall weighted cost of capital of 9.72 percent less the common equity component of 4.64 percent. The actual calculation of the interest expense deduction to be used in the determination of the pro forma income tax amount will depend on the final rate base, the capital structure, and the capital cost rates that the Department orders in this case.

Tr. 2 pp. 154-156 and RR-DTE-3. The proposed rates continue the movement toward full cost of service recovery by increasing the rates by approximately \$8,500 annually. According to the Company's bill impact analyses, the proposed rates would increase the school's total bill by approximately 13.5% during the peak months and approximately 17.5% during the off peak months. Exh. B-1, exhibits 8 and 9. Even with this level of increase in the school's rates, they remain significantly below fully allocated embedded costs. According to the Company's updated allocated cost of service study the school's responsible for approximately \$26,000 of the total deficiency of \$163, 000 (16%). Exh. B-4, exhibit 2, schedule 1. The Company's proposed school rates are designed to recover less than \$8,500 of the school's \$26,000 deficiency¹³. Exh. B-1, exhibit 7 and Exh. B-4, exhibit 2, schedule 1.

The Company's proposal to continue to move the school's rate closer to its cost of service is understandable, especially given the fact that the Company is currently serving other schools in its service territory under its cost based G-1 tariff and there is no basis for continuing to the rate disparity. Tr. 2, pp.155-156. However understandable the proposal may be, the Attorney General disputes the Company's attempt to burden other customers with the remaining discount during the time it takes to move the school's rates to the level that could be considered to be recovering their embedded costs. The Department has addressed the issue of discounted special contracts in the post-restructuring world and has ruled that any discount provided under a special contract "is not recoverable from remaining ratepayers." *See Investigation by the Department on its own Motion to*

¹³ Compare "Required Increase/(Decrease)", Exh. B-4, exhibit 2, schedule 1 (\$25,555) with "School Base Revenue Target", Rate Design Worksheet, Exh. B-1, exhibit 7 (\$19,235) less "Normal Base Revenue", Exh. B-4, exhibit 2, schedule 1 (\$10,966) [\$25,555, fully allocated deficiency vs. \$8,269—revenue increase from proposed school rate]. The Company's proposal leaves the Company's other customers subsidizing the school by more than \$17,000 annually (school deficiency, \$25,555 minus additional revenues from proposed rate design, \$8,269); assuming that the originally proposed rate design revenue target is implemented.

Revise the Standard of Review for Electric Contracts Filed Pursuant to G.L. c. 164, § 94, D.P.U./D.T.E. 96-39-A (1998). The Department has denied recovery of discounts from tariff rates in pre-restructuring cases. *See Massachusetts Electric Company, D.P.U. 95-40 (1995); Boston Edison Company, Manufacturing Retention Rate, Department Letter Order dated February 28, 1995; Fitchburg Gas and Electric Light Company, EC 95-19, Letter Order dated October 25, 1995.* The Company's proposed school tariff, as described by Ms. Smith, is nothing more than an attempt to move a customer from a "discounted" rate to one that eventually recovers its full cost of service. Tr. 1, pp. 93-98. Until such time as the school is recovering its fully allocated costs or is on the G-1 tariffs (as are all other schools the Company serves), other customers should not be responsible for any continuing level of "discount" provided to the school. As discussed below, the Attorney General recommends phasing in full cost recovery rates for the school.

Although the Company is free to sell to the school according to a special contract, tariffs of general applicability must be based on the cost to serve those customers. *See Boston Gas Company, D.P.U. 90-17/18/55, pp.12-14 (1990); Whitenville Water Company, D.P.U. 96-111, p.4 (1997).* Should Blackstone not serve the school under a special tariff, and decides to charge a cost based rate, any increases should be phased in. The amount and impact of a second step of the "phase in" can be derived when the final deficiency is determined in this case. As part of the Company's compliance filing it should include moving half the remaining deficiency into a second phase school rate adjustment to be implemented on the third anniversary of the effective date of the rates established in this proceeding. The three year period would provide a reasonable notice of the new rate--time for the schools to adjust to the new rates and prepare for the known increase. This phase-in approach has been approved by the Department in other cases to mitigate significantly adverse bill

impacts and to address continuity issues. *Western Massachusetts Electric Company*, D.P.U. 85-270, p. 129 (1985) (Approving a 5 year Phase-in of Millstone 3 Investment). *Boston Edison Company*, D.P.U. 92-92, pp. 37-40 (1992) (Phase in of Customer Charge Increases).

2. ACTUAL BILLING DETERMINANTS MUST BE MAINTAINED

The Company does not maintain its revenue accounts in sufficient detail to allow the identification of individual class billing determinants. As a result, rate design bill determinants relied on in this case were developed separately by making assumptions and inferences regarding block usage and zero/low use. Tr. 1, p.103, Exh. AG-4-15 and RR-AG-15. Accurate billing determinants are critical to rate design continuity and fairness and to assure that there is no windfall to the Company as the result of applying a Department approved revenue level to distorted determinants. *Boston Gas Company*, D.T.E. 97-92-A, (1998). The Attorney General requests that the Department require the Company to immediately begin to maintain actual billing determinant data, and, in its next base rate case, reconcile its rate design, weather normalized bill determinants to its actual test year determinants. Furthermore, the Company should be required to provide bill frequency data as part of its bill impact analyses to show what portion of a class will experience the anticipated impact of proposed rates.

III. CONCLUSION

WHEREFORE, for all of the foregoing reasons, the Attorney General submits that the Department should reject the Company's proposed new rates and tariffs, or in the alternative, adopt the Attorney General's pro forma adjustments.

RESPECTFULLY SUBMITTED,

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